

# PROMOTING ECONOMIC GROWTH: THE RIGHT TAX POLICY FOR ALBANIA

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## Abstract

Since 2010, as a clear outcome of the financial and economic crisis throughout Europe and the world, the total tax revenues in Albania have been falling steadily. For the first couple of years, government choose to borrow to maintain and stimulate the economy to keep growing, albeit very slowly. But, starting in 2013, since the level of public debt reached almost 65 percent of the Gross Domestic Product, changing taxation policy was the better way out. Taxes were increased, but without the intended results: revenues did not increase and economy did not grow. This paper, while examining the situation of the economy of Albania, intends to discover whether it is consumption or investments that is hampering recovery and growth. The paper will also show what were the outcomes of the taxation policies adopted and whether the tax increase hit the consumers or investors. Referring to data collected from secondary sources and to theoretical approaches on taxation and growth stimulation, this research intends to add some recommendations as to the better taxation policy to be chosen to ease the way out of this crisis.

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**Keywords:** Financial crisis, taxation policies, consumers, investors, revenues

## Introduction

Albania is a country of about 3 million inhabitants, with an emerging market economy. The Gross Domestic Product in 2014 was of roughly USD 13.6 billion and this year is projected at USD 14.5 billion (IMF, 2014). However, it has taken Albania almost 25 years to reach this level of development.

At the beginning of 1990s, Albania moved away from the centralised socialist economy, embracing the free market economy. In 1991, the GDP was a mere USD 1.6 billion, the lowest since 1970. Thus, it was clear that things could not get any worse, and the only way left for the economy was to grow. From 1993 to 2011, the economy grew on average by 6.1 percent.

But, even though Albania was not directly hit by the 2008 financial crisis, its effects started to show their impact. Starting by 2011, investment started to fall, especially the foreign direct investments. During 2012, 2013 and 2014, economy grew on average by only 1.5 percent. However, the growth was made possible by increasing government spending through borrowing. The public debt limit of up to 60 percent of the GDP, which was imposed by law in 2008, was broken. Starting by 2014, in order to keep up the level of falling revenues, government radically changed the taxation scheme, imposing an across the board increase.

The 2015 state budget stands at USD 3.8 billion (based on the exchange rate of ALL 1 = UDS 0.008, published in August 21, 2015, by the Bank of Albania). The total revenues for this year are estimated at USD 3.3 billion. However, in July, the government was forced to revise the budget, cutting it by USD 131.5 million because the revenues, for the first six months of the year, did not meet expectations. An International Monetary Fund mission in Tirana, in June 30, 2015, stated that “[t]here has been a shortfall in tax revenues in the January - May period compared to the budget, because of lower oil prices and production and weakness in tax compliance and administration” (IMF, 2015). This has also put great doubts on achieving the projected economic growth of 3 percent.

The 2015 so far has shown that the new taxation policy has not worked out well, indicating that there are elements which do not reflect the reality of the economic situation. Almost all taxes were increased by 50 percent, whereas the revenues keep falling.

### **Materials & Methods - Taxation System of Albania**

Data is collected from various secondary sources, and it refers to the taxes and taxation system of Albania, as well as the revenues and budget created through them. Throughout this section, comparisons are made among various taxations and various strategies used by the government to promote economic growth in midst of crisis.

In Albania, parliament is the only body with the right to impose taxes and nobody is obliged to pay a tax if there is no law requiring it. Unless otherwise stipulated by law, taxes are to be paid on yearly basis. Before each new fiscal year starts, the government will submit to the parliament its proposal for the level of each and every tax.

Taxes in Albania are divided into two categories: *direct taxes* and *indirect taxes*. Direct taxes include all dues that have to be paid directly to the government, meanwhile indirect taxes represent all dues generally included in the price of goods and services and are paid when purchasing such goods and services. Referring to the tax collecting authorities, taxes in Albania can also be divided into *national taxes*, which are paid to and

collected by the central government, and *local taxes*, which are paid to and collected by local government units.

<b>National Taxes</b>	<b>Level</b>	<b>Explanations</b>
Port Tax	USD 1.13	This tax is to be paid by all ships when entering any of the ports in Albania
Motor Vehicle Tax	from USD 31.95	This tax is paid every year and is calculated based on the fuel used by the motor vehicle, engine displacement and its production year
Petrol & Diesel Tax	USD 0.21 per litre	This tax is added to the price of fuel and is paid when purchasing it
Minerals Resource Rent Tax	4 percent to 10 percent	Depending on the type of product mined, the tax represent a percentage of all income generated by its sale and is to be paid right after every sale transaction
Carbon Tax	USD 0.01 per litre of petrol USD 0.02 per litre of diesel USD 0.02 per kilogram of coal USD 0.02 per litre of other fuels	This tax is added to the price of fuel and is paid when purchasing it
Stamp Tax	USD 0.40 to USD 16.14	This tax is levied on most documents issued by different state authorities and is paid when applying for such documents
Fishing Tax	from USD 8.07 to USD 726.33	This tax is paid every year for each fishing boat, depending on its size and fishing capacity
Plastic Packaging Tax	USD 0.40 to USD 0.80 per kilogram	This tax is to be paid by all importers or producers of plastic packaging right after every sale transaction
Public Land Usage Tax	10 percent of land's value	This tax is to be paid every year and is levied on all public land used by private subjects, with the exception of agricultural land
Written Premiums Tax	3 percent of the premium amount	This tax is to be paid by all the subjects writing such premiums on each premium they write
Corporate Tax	15 percent	This tax is to be paid every year and it represents 15 percent of the total profit generated (after costs recognised as such by law are deducted)
Corporate Tax (oil and gas exploration)	50 percent	This tax is to be paid every year and it represents 50 percent of the total profit generated (after costs recognised as such by law are deducted)
Personal Income Tax (from employment)	from 13 percent to 23 percent	This tax is to be paid every month and is a progressive tax imposed on the income generated from being employed
Withholding Tax	10 percent	This tax is imposed on income from dividends, royalties, interest rates on deposits, etc. and it is paid when such income is collected
Value Added Tax	20 percent	This tax is added to every sale and purchase transaction and is paid right after that transaction
Health Insurance Tax	equal to 3.4 percent of employee's gross salary	This tax is paid every month, and 50 percent of which is paid by the employer and 50 percent is paid by the employee
Social Security Tax	equal to 24.5 percent of employee's gross salary	This tax is paid every month, and 63 percent of which is paid by the employer and 37 percent is

		paid by the employee
Excise Tax	varies greatly according to the goods it is imposed on (fuel, alcoholic and energy drinks, coffee, tobacco, luxury goods, etc.)	This tax is added to the sale price of the goods it is imposed on and it is paid when purchasing such goods

Table 1. National taxes, applicable in Albania as of 1 January 2015 (Ministry of Finance, 2014)

Starting in 2014 and carrying on to 2015, almost all taxes we raised by at least 50 percent. Prior to 2014, the personal income from employment was subject to a flat tax of 10 percent. Meanwhile, by 2014, such personal income became subject to a progressive tax which starts at 13 percent and goes up to 23 percent. Since 1992, this is the highest personal income from employment tax ever imposed. However, the personal income from other sources (dividends, royalties from intellectual property rights, etc.) remained unchanged and subject to a flat tax of 10 percent. The corporate tax was also raised to a flat 15 percent, from 10 percent that used to be until 2013. The excise taxes on coffee, energy drinks, tobaccos and cigarettes, fuel, alcoholic drinks, luxury goods were raised from 22 percent to 100 percent (Ministry of Finance, 2014).

Local taxes in Albania are negligible. They are more in the form of tariffs to be paid every year to the local government units, and they are imposed on real estate and agricultural land, for the public service of waste collection, for the street lights and traffic signals, etc.

There is no doubt that Albania's economy is in midst of a crisis. In 2008, economy grew by 7.5 percent, but in 2009 it grew only by 2.8 percent. In subsequent years, the growth level was a mere 1.3 percent. From 2009 to 2013, government chose not to increase taxes and tried to keep up its public investments by increasing public debt through borrowing and privatisations. The public debt limit of up to 60 percent of the GDP was broken. Somehow, these moves kept the economy going, albeit slowly. Starting in January 2009, Bank of Albania started gradually slashing its benchmark interest rate. At the end of 2008, the interest rate applied by the Bank of Albania was 6.25 percent, whereas now it stands at 2 percent. Such a move by Albania's central bank was made with the intention to keep up the demand for goods and services (Fullani, 2014).

At first, it worked. But, the ever growing public debt put the government under pressure and it could no longer borrow at will. By 2010, the financial crisis in Europe was in full fledge and this led to a free fall of foreign investments. Remittances, which are an important growth factor, fell drastically. In 2007, remittances stood at a little bit more than USD 1.3

billion, meanwhile by 2013 they were USD 745 million (Open Data Albania, 2015).

At the end of 2013, government of Albania entered into an agreement with the IMF for a USD 437.1 million three-year loan, under the Extended-Fund Facility, which was to support a wide reform program. But, under that agreement, Albania has to reduce the public debt, which meant that it could no longer borrow. On the other hand, to keep revenues from falling, taxes had to be increased.

In a nutshell, during the last two years, this has been the taxation policy in Albania: increase taxes to keep revenues growing. Unfortunately, there was no study undertaken in order to identify whether the Albania's economy was in crisis because of its own bad decisions or because its main trade partners, Greece and Italy, were in recession. About 70 percent of Albania's exports go to Italy and Greece, and about 60 percent of imports are sourced from there (INSTAT, 2015). On the other hand, there was also no study as to what were the greatest unused financial resources, so that the burden of higher taxes could fall on them.

The result was an across the board increase of taxes and, as an outcome to that, higher revenues were expected. But, revenues did not meet expectations, which is also an indicators that a good part of the economy had gone informal.

### **Discussion - Growth Promoting Taxation Policy**

The jury on whether taxes suppress or promote economic growth is still out. Even though many scholars are of the opinion that higher taxes harm growth, this is not a generally accepted position. However, as quoted in Huang and Frenz (2014), it is universally accepted, as stated by Prof Joel Slemrod, a tax economist of the University of Michigan, that "taxes affect behaviour, they affect some behaviours more than others."

Since the beginning of the 1990s, the main drivers for Albania's economy to grow were foreign investments, privatizations, exports, and remittances. But, since 2010, all these drivers were fading away, and economy is still underperforming, since there is no market for its products and services.

However, this financial crisis that hit Europe hard, and which affected Albania as well, could have been used as a blessing in disguise. It could have been the best chance for Albania's economy to shift from an investment-led growth to consumption-led growth, or, at least, consumption could have a greater role in promoting growth.

Albania's central bank, in order ensure a sustainable economic growth and avoid drastic price fluctuations, has always tried to keep the inflation rate at 3 percent, having set the 2 percent as the lowest accepted

level and the 4 percent as the highest accepted level. But, since 2010, inflation rate is stuck at the minimum of 2 percent. At times, like in 2013 and 2014, it even fell below that level, reaching 1.7 percent. This is a clear indication that consumption is at the lowest point ever. The *Albania Country Risk Report*, published by BMI Research, notes that “Albania will remain attached to a relatively low growth trajectory over the coming years, amidst weak private consumption and government fiscal consolidation efforts” (BMI Research, 2015). Bank of Albania has continuously cut its benchmark interest rate, but nothing has changed. Even though low interest rates have made saving less profitable, consumption has not grown. On the other hand, low interest rates did not bring about any notable growth in loans and investments. Even though now it is cheaper for the business to borrow and invest, consumption seems to be the main factor keeping business from expanding, and this has stalled the economy.

The underlining issue here is the taxation policy chosen by the government, which is not exactly the right policy. The main question is whether the burden of higher taxes should be borne by the business or by the consumers? Clearly, the strategy chosen, in order to have the consumers pay more, has not proven effective.

In order to balance the budget and keep up the revenues, government has no other choice, but to raise taxes. On the other hand, the crisis has also catalysed the urgency to implement the much needed structural reforms. Yet, the government has taken the easiest way out to balance the budget and increase revenues. Most of the tax hikes implemented fall directly or indirectly on the consumers, affecting their behaviour. This has made consumers a lot more careful on what they spent. Meanwhile, corporate tax, which stands now at 15 percent, even though it was raised by 50 percent, is still low compared to other neighbouring countries. The low corporate tax, together with the lack of private investments, means that business is holding back on their money.

This is high time for the government to make the right, and maybe difficult, decision to further raise the corporate tax. But, austerity alone would further suffocate the economy. Prof Robert J. Shiller, a Nobel prize laureate in economics, notes that “[t]his is the paradox of thrift: belt-tightening causes people to lose their jobs, because other people are not buying what they produce, so their debt burden rises rather than falls” (Shiller, 2013).

So, apart from raising taxes, which is inevitable in order to balance the budget, and apart from making the right decision about which tax to raise, government must also make sure to keep up investments. This will help fill the gap left wide open by the lack of private investments and it will also stimulate consumption. Increasing public investments would also offer

the government the chance to even borrow more, since the debt to GDP ratio would not increase. Prof Robert J. Shiller calls this intervention as “debt-friendly stimulus” (Shiller, 2013).

### **Conclusion - Recommendations**

Increasing taxes in times of crisis, especially when the debt to GDP ratio has become unsupportable, is inevitable. However, government must take all precautionary measures to see which taxes can be increased, as well as identify stimulation policies to ease the austerity.

The underlining strategy for the government should be to collect the financial resources that are being left unused. Taking into consideration Albania's economic reality, it is not the consumers that have any great unused financial resources. And, even if they have, the objective must be to make them spend such financial resources.

The best approach would be to further increase taxes on the business. This would assist the government to keep up the revenues. But, the government should not be simply confined to the improved level of revenues. In these times of crisis, government should take a proactive role to lift the economy of Albania out of conundrums. The government must take the initiative to stimulate consumption by increasing public investments. Such an increase in investments would increase the output, which would also improve the debt to GDP ratio, and this would also allow for some new borrowing.

The sole purpose of the taxation policy should not be to increasing revenues, but the main aim must be to promote growth. At the moment, consumption in Albania is at the lowest point ever. Taxing consumers would make them even more afraid and suspicious about increasing expenditures. But, increasing the burden of taxes on the business, which would improve revenue collection, and accompanying this approach with increased public investments would alleviate fears and increase consumption. That would be the moment when the economy would pick up.

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